78-561
No.

In the Supreme Court of the United States

OCTOBER TERM, 1978

UNITED STATES OF AMERICA, PETITIONER

v.

NEIL T. NAFTALIN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

WADE H. MCCREE, JR.
Solicitor General

STEPHEN M. SHAPIRO
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530

DAVID FERBER
Solicitor to the Commission

JAMES H. SCHROPP
Assistant General Counsel

LARRY R. LAVOIE
Attorney
Securities and Exchange Commission
Washington, D.C. 20549

INDEX

CITATIONS

Cases:

In the Supreme Court of the United States

OCTOBER TERM, 1978

No.

UNITED STATES OF AMERICA, PETITIONER

v.

NEIL T. NAFTALIN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. A, *infra*, 1a-11a) is reported at 579 F.2d 444. The opinion of the district court (App. D, *infra*, 15a-20a) is not reported.

JURISDICTION

The judgment of the court of appeals (App. B, *infra*, 12a-13a) was entered on June 13, 1978. A timely petition for rehearing was denied on August

4, 1978 (App. C, *infra*, 14a). On August 31, 1978, Mr. Justice Blackmun extended the time for filing a petition for writ of certiorari to and including October 3, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether Section 17(a)(1) of the Securities Act of 1933 prohibits fraudulent practices that injure brokers who serve as intermediaries in securities transactions but who are not themselves investors.

STATUTORY PROVISIONS INVOLVED

1. Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1), provides in part:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud * * *

2. Section 2(3) of the Securities Act of 1933, 15 U.S.C. 77b(3), provides in part:

> The term * * * "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

STATEMENT

1. Respondent, the principal of a registered broker-dealer firm and a sophisticated professional investor, engaged in a "short selling" scheme. Respondent selected stocks that, in his judgment, had peaked in price and were entering into a period of market decline. He then placed with brokers orders to sell shares of these stocks, although he did not own the shares he purported to sell (App. D, *infra*, 16a-18a). Gambling that the price of securities would decline substantially before he was required to deliver them,[1] respondent planned to make offsetting purchases through other brokers at lower prices and to take as profit the difference between the price at which he sold and the price at which he covered. Respondent falsely represented that he owned the shares he "sold;" he knew that the brokers who executed the sell orders would not have accepted them had they known that he did not own the securities (*id.* at 17a).[2]

---

[1] A broker may immediately execute an order to sell a customer's shares if it "is informed that the seller owns the security ordered to be sold and, as soon as is possible without undue inconvenience or expense, will deliver the security * * *." 17 C.F.R. 240.10a-1(d).

[2] By misrepresenting his ownership of the shares, respondent avoided the requirement that "short" sellers (that is, persons who sell a promise to produce shares in the future) make a substantial "margin" deposit with the brokers. See Regulation T, 12 C.F.R. 220.8(d). Brokers executing short sales are protected by such deposits against market fluctuations. Respondent's scheme, known colloquially as "free riding," is also described in *Naftalin & Co.* v. *Merrill Lynch,*

The market prices of the securities that respondent "sold" rose sharply prior to the settlement date. He was unable to make covering purchases, and he never delivered the securities (App. D, *infra*, 18a). The five brokers with whom respondent had placed the sell orders had in turn promised to deliver the shares to investors at the prices prevailing when respondent began his scheme. In order to keep their delivery promises, the brokers purchased the stock on the open market, a process known as "buying-in," at an aggregate loss to themselves of more than $1,000,000.[3]

2. After making the findings described above, the district court found petitioner guilty on eight counts of employing a scheme or artifice to defraud in the sale of securities, in violation of Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1). See App. D, *infra*, 15a-20a. Although the court of appeals thought the evidence sufficient to establish that respondent committed fraud (App. A, *infra*, 5a), it reversed his convictions. Reasoning that the purpose of Section 17(a)(1) is to "protect investors from fraudulent practices in the sale of securities" (App. A, *infra*, 6a-7a), the court concluded that "the gov-

Pierce, Fenner & Smith, Inc., 469 F.2d 1166, 1171-1172 (8th Cir. 1972), which found that he had engaged in "obvious and calculated wrongdoing."

[3] When a sell order is executed, and the seller fails to make delivery when due, the broker normally must "buy-in" substitute securities for the purchasers. See 17 C.F.R. 240.10a-2(a). See also 2 L. Loss, *Securities Regulation* 1229-1235 (2d ed. 1961). This "buy-in" procedure serves as a form of insurance for investors who purchase securities.

ernment must prove some impact of the scheme on an investor" (*id.* at 8a). Because respondent's fraud injured brokers rather than investors, the court held, respondent's acts did not violate Section 17(a)(1).

The court reversed the conviction on the sixth count of the indictment even though that count involved fraud on a broker who traded for his own account as an investor (App. D, *infra*, 17a). The court reasoned that "the indictment did not allege that [the defrauded broker] was a purchaser and * * * [respondent] could not be tried on charges that were not made" (App. A, *infra*, 10a).[4] Judge Ross dissented from the court's disposition of Count 6 of the indictment (*id.* at 11a).

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals, which limits the coverage of Section 17(a)(1) to fraudulent practices injuring "investors," effectively removes federal criminal prohibitions against fraudulent securities

[4] We believe that the court's disposition of Count 6 is improper even assuming, for this purpose, that Section 17(a)(1) applies only to fraud on "investors." Ordinarily an indictment is sufficient if it sets out the language of the statute and the essential facts of the offense. *Hamling* v. *United States*, 418 U.S. 87, 117 (1974). Count 6 unquestionably is sufficient under the standard of *Hamling*. But because the court's treatment of Count 6 appears to involve only the (mis)application of settled principles to particular facts, we do not present it as a separate question for this Court's review. Of course, if the Court should accept our construction of Section 17(a)(1), it would follow that the convictions on all counts should be reinstated.

schemes in which the fraudulent statements are made to financial institutions serving as intermediaries in securities transactions. But the statute applies on its face to all fraudulent practices in "the offer or sale of any securities." This language prohibits fraud aimed at non-investor financial institutions. The Second Circuit has applied Section 17(a)(1) at face value, squarely rejecting the "investor" limitation adopted by the court below. See *United States* v. *Brown*, 555 F.2d 336, 338-339 (2d Cir. 1977).[5]

The decision in this case deprives the United States and the Securities and Exchange Commission of power to protect the principal participants in the nation's securities markets under Section 17(a)(1). Because protection of such participants from fraudulent schemes is essential to the integrity of the securities marketplace, this Court should review the court of appeals' decision and resolve the conflict among the circuits.

---

[5] Brown was prosecuted under Section 17(a)(1) for submitting counterfeit stock certificates to a transfer agent and obtaining genuine certificates in smaller denominations in exchange. Brown contended that his scheme was designed to defraud the transfer agent rather than any investor. The court of appeals, noting that Section 17(a)(1) "broadly condemns the employment of "any device, scheme, or artifice to defraud'" (*id.* at 339), stated that "there is no doubt that Congress in the broad language employed in [Section 17(a)(1)] was intent upon protecting the integrity of the marketplace in which securities are traded" (*ibid.*).

1. "'The starting point in every case involving construction of a statute is the language itself.'"[6] Section 17(a)(1) forbids "any person in the offer * * * of any securities * * * directly or indirectly * * * to employ any device, scheme, or artifice to defraud." Section 2(3) defines "offer" to include "every attempt or offer to dispose of * * * a security * * * for value."[7] Respondent placed "sell" orders for value with various brokers, and he employed a scheme to defraud in the course of placing those orders. The statute unambiguously proscribes respondent's conduct.

"Nothing on the face of the statute suggests a congressional intent to limit its coverage" (*United States* v. *Culbert*, No. 77-142 (March 28, 1978), slip op. 2) to fraud practiced on investors. Just as it was improper to restrict the scope of the Hobbs Act "by reference to an undefined category of conduct termed 'racketeering'" (*id.* at 9), so it was improper for the court of appeals to restrict the scope of Section 17(a)(1) to "the species of fraud" aimed at "investors" (App. A, *infra*, 5a). Here, as in *Culbert*, the broad

---

[6] *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472 (1977).

[7] "The definition of 'offer' is obviously much broader than the common law concept." 1 L. Loss, *Securities Regulation* 512 n.163 (2d ed. 1961). See also *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467 n.8 (1969).

words of the statute "do not lend themselves to [such a] restrictive interpretation." [8]

We do not doubt that investor protection is an essential purpose of the Securities Act of 1933, just as the prevention of "racketeering" is an essential purpose of the Hobbs Act. But statutes commonly have more than one purpose and strike at more than one evil. So it is with the Securities Act of 1933. This Court summarized the general objectives of the statute in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976) (emphasis added):

> The Securities Act of 1933 * * * was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, *to promote ethical standards of honesty and fair dealing.*

A principal purpose of the federal securities laws is "to insure the maintenance of fair and honest markets." 15 U.S.C. 78b.[9] Conduct that defrauds financial intermediaries such as brokers strikes at the heart of the securities markets.[10]

[8] This Court has often held that the securities laws should be interpreted broadly to effectuate their remedial purposes in government enforcement actions. See *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467 (1969); *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351 (1943).

[9] Consistent with this purpose, it is "well settled" in the lower courts "that in a prosecution [under Section 17(a)(1)] the government is not required to prove that anyone was defrauded or that any investor sustained loss." *Farrell* v. *United States*, 321 F.2d 409, 419 (9th Cir. 1963) (collecting cases). See also *United States* v. *Brown*, *supra*.

There was therefore no reason for the court of appeals to invoke the "rule of lenity" to narrow the literal application of Section 17(a)(1). As this Court observed in *United States* v. *Culbert*, *supra*, slip op. 8-9: "It is true that 'ambiguity concerning the ambit of criminal statutes should be resolved in favor of lenity'. * * * But here Congress has conveyed its purpose clearly, and we decline to manufacture ambiguity where none exists." See also *Scarborough* v. *United States*, 431 U.S. 563, 577 (1977). Because Section 17(a)(1) is literally applicable here, there is no ambiguity and no necessity to resort to rules of construction intended to resolve statutory uncertainties. See *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 354-355 (1943).

[10] It has long been recognized that Rule 10b-5, 17 C.F.R. 240.10b-5, which was based on Section 17(a) (see *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 213 n.32), prohibits fraud practiced on "brokers." See *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 396-397 (2d Cir. 1967): "Neither § 10(b) nor Rule 10b-5 * * * speaks in terms of limiting the nature of the violation to one involving fraud on 'investors'; nor is there any justification for reading such an additional requirement into the act. * * * We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, wehther the artifices employed involve garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

2. Even if it were correct to conclude that the 1933 Act protects investors only, it would not follow that frauds practiced on brokers are beyond the coverage of the statute. A broker usually acts as the agent of buyers and sellers. If the seller does not have the promised shares, they cannot be delivered to the buyer, and the buyer may suffer loss as a result. That loss is averted in cases like the present one by the requirement (see 17 C.F.R. 240.10a-2(a)) that the broker "buy in" real shares to deliver to the buyer of the phantom shares. This, like insurance, transfers the buyer's loss to a financial intermediary. Like insurance, it has a cost; in the long run it raises the brokerage fees paid by investors. And if, in some cases, brokers should be financially incapable of "buying in" to protect investors from loss, then investors would bear the loss directly.

It is not logical to conclude that the "species of fraud" practiced by respondent was beyond the scope of the securities laws simply because the investors were "insured" by the brokers' "buy in" of shares. As the Second Circuit pointed out in *United States* v. *Brown*, *supra*, 555 F.2d at 339, "[o]ne might as well argue that if Brown stole [some person's] fully insured automobile, he was never the victim of a larceny." The court continued (*ibid.*):

> The fact that the Uniform Commercial Code might ultimately shift the monetary loss from Smith and ultimate investors hardly serves to exculpate Brown and his group of fellow thieves, counterfeiters and forgers from criminal responsibility. This was not of course the garden variety of security fraud—its long planned execution * * * constituted a massive assault upon innocent investors and brokerage houses and their normal business procedures which we cannot construe the statute to countenance.

Fraud practiced on brokers results in greater losses to them, or perhaps in costly precautions to avoid loss. The costs of loss or precautions are ultimately borne by persons who use the services of brokers—the investing public. The decision below removes an important deterrent to fraud practiced against brokers, and, in the end, must serve to render brokerage services more costly or more cumbersome, to the detriment of all traders in securities.

3. At all events, the decision of the court of appeals seriously impairs the ability of the United States and the Securities and Exchange Commission to enforce the securities laws in cases involving fraud practiced on the largest participants in the national securities markets.[11] Brokers are integral parts of the securities exchange process, handling sales and

[11] The reasoning of the court below—that the "purpose" of the statute was to protect investors, and that mere agents are therefore beyond protection—would seem to apply equally under Section 10(b) of the 1934 Act, 15 U.S.C. 78j(b), as well as Section 17(a) of the 1933 Act. Indeed, the court placed principal reliance on authorities construing Section 10(b) (see App. A, *infra*, 7a). Thus, the decision of the court of appeals may mean, as a practical matter, that government enforcement actions under Section 10(b) will also be foreclosed in the Eighth Circuit in cases involving fraud on brokers and other securities professionals.

consummating purchases for customers throughout the nation.[12] The amount of money involved in such transactions is enormous. In 1975 brokers participated in securities transactions on national exchanges with a dollar volume of $166.9 billion. See *42d SEC Ann. Rep.* 192 (1976). Because Section 17(a) authorizes not only criminal prosecutions but also civil remedies, the effect of the decision here is to abolish one of the government's most effective weapons against the most serious forms of securities fraud practiced on members of the brokrage industry.[13]

The decision of the court of appeals also would bar government enforcement actions in cases where other financial institutions—including transfer agents, investment advisers, and commercial bank trust departments—have been defrauded. In each case it could be argued, with equal logic, that the defrauded financial intermediary was not an actual "investor" or "purchaser" of securities, and thus was beyond the scope of statutory protection.

---

[12] "The securities markets of the United States are indispensable to the growth and health of this country's and the world's economy. In order to raise the enormous sums of investment capital that will be needed in the years ahead and to assure that capital is properly allocated among competing uses, these markets must continue to operate fairly and efficiently." H.R. Conf. Rep. No. 94-229, 94th Cong., 1st Sess. 91 (1975).

[13] There is no question in this case of enforcing a private implied right of action or of conferring "standing to sue." See *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975); *Piper* v. *Chris-Craft Industries, Inc.,* 430 U.S. 1 (1977). This criminal prosecution is squarely predicated on Congressional grants of jurisdiction. See 15 U.S.C. 77q(a), 77x.

Brokers, transfer agents and investment advisers are subject to pervasive regulation under the federal securities laws. See 15 U.S.C. 78o *et seq.*, 15 U.S.C. 78q-1 *et seq.*, 15 U.S.C. 80b-1 *et seq.* Congress has not demonstrated any intent to impose the burdens of the securities laws on these financial institutions without conferring the protections of the securities laws, and those protections therefore should be available where, as here, they are literally applicable.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

WADE H. MCCREE, JR.
Solicitor General

STEPHEN M. SHAPIRO
Assistant to the Solicitor General

DAVID FERBER
Solicitor to the Commission

JAMES H. SCHROPP
Assistant General Counsel

LARRY R. LAVOIE
Attorney
Securities and Exchange Commission

OCTOBER 1978

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 77-1290

UNITED STATES OF AMERICA, APPELLEE

v.

NEIL T. NAFTALIN, APPELLANT

Appeal from the United States District Court for the District of Minnesota

Submitted: August 30, 1977
Filed: June 13, 1978

Before BRIGHT, ROSS and HENLEY, Circuit Judges

HENLEY, Circuit Judge.

Neil T. Naftalin, appellant here and defendant in the district court, was indicted on eight counts of employing a scheme to defraud in the offer or sale

of securities, in violation of § 17(a)(1) of the Securities Act, 15 U.S.C. § 77q(a)(1). Appellant was tried without a jury in the United States District Court for the District of Minnesota and found guilty on all eight counts. He was sentenced to five years imprisonment on each of the eight counts, to be served concurrently. This court has jurisdiction on appeal under 28 U.S.C. § 1291.

The alleged schemes to defraud consisted of appellant ordering five different brokers in eight separate transactions to sell stock listed on the New York Stock Exchange that appellant did not own at the time of the orders, either without disclosing that he did not own the stock or by affirmatively misrepresenting that he did own the stock. Counts I-V, VII and VIII of the indictment arose out of sell orders placed with various broker-dealers whereby the brokers became appellant's agents for the purpose of finding buyers for the stock and transferring the stock to the third party purchasers. Count VI, presently to be discussed separately, differs from the other counts in that the evidence adduced in support thereof shows that on August 28, 1969 H. S. Kipnis and Co., the brokerage house involved, purchased the securities mentioned in that count as a principal rather than acting as appellant's agent for the sale of the securities to third parties.

Appellant was the president and controlling shareholder of Naftalin and Co., Inc. (Company), a corporation registered as a securities dealer under federal and Minnesota securities laws. Prior to 1963,

the Company operated a public business as a broker-dealer. After 1963, and at the time of the transactions involved in this case, the Company had ceased doing business with the public and was operated essentially as a one-man business with appellant conducting all of its affairs.

From 1966 until the time of the transactions involved in this case, appellant had been trading for the Company's account in a number of stocks. The pattern of trading which appellant established during this period, and particularly in the summer of 1969, was to place large sell orders in the Company's name with various broker-dealers for listed stocks. Delivery of the securities for these transactions was often made weeks or months after the settlement dates set forth in the confirmation slips prepared and mailed to the Company by the brokers.[1]

Naftalin was, and is, a knowledgeable and sophisticated professional investor. It is possible that such a person can sell securities that he does not own without at the time disclosing he does not own them or representing falsely that he does own them. If before delivery of the securities is required the market price declines the seller can buy in the securities at a lower price and pocket the difference. Of course, if the market advances the seller suffers loss, and if

[1] A good description of Naftalin's over-all "short-selling" or "free-riding" mode of operation during the indictment period may be found in *Naftalin & Co.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166, 1170 (8th Cir. 1972). *See also United States* v. *Naftalin*, 534 F.2d 770 (8th Cir.), *cert. denied*, 429 U.S. 827 (1976).

he does not deliver the securities the broker through whom he sells suffers loss. To be sure, a seller lawfully may sell stock he does not own "short" if he discloses at time of sale that he is short and if he maintains appropriate brokerage accounts and otherwise trades according to prescribed procedures. However, the government charges in essence that undisclosed short sales misrepresented as sales of stock owned by the seller, *i.e.*, "long" with intent to deceive the broker and take a free ride on the broker's money or credit are made unlawful by § 17(a)(1) of the Securities Act, 15 U.S.C. § 77q(a)(1).[2]

Appellant never delivered any of the stock which he had agreed to deliver pursuant to the sell orders included in this case. With regard to Counts I-V, VII and VIII, when appellant failed to deliver the stock involved, the brokers ultimately purchased stock

[2] Securities Act of 1933, 15 U.S.C. § 77q(a):

Sec. 17(a). It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) To employ any device, scheme, or artifice to defraud, or

(2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(3) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

sufficient to cover the sales which they had arranged with third party purchasers. With perhaps one exception, the indictment transactions resulted in loss to the brokers. There is no evidence that any of the third party purchasers were deceived or defrauded in any way.

Appellant urges on appeal that the evidence adduced at trial was insufficient as a matter of law to support the district court's finding of fraud. While we are convinced there is no merit to that claim we pretermit further discussion of it and the factual details of the fraudulent acts at this juncture because we are not persuaded that the provision of § 77q(a)(1) under which appellant was put to trial is violated by the species of fraud practiced against the defrauded brokers who were not purchasers, and for that reason we reverse on all counts other than Count VI.[3]

With respect to the counts now under consideration, the government argues that the issue is whether the government alleged and proved a device, scheme or artifice to defraud in the offer or sale of a security. And the government insists that 15 U.S.C. § 77q(a)(1) does not require that the purchaser be defrauded,

[3] Other issues raised on appeal are (1) that the district court had no jurisdiction with regard to Counts I—V because of a lack of proof of use of the mails by appellant; (2) that sentencing on eight counts was improper since the proof showed only a single scheme to defraud; and (3) that appellant was exposed to double jeopardy due to prior disciplinary action which had been taken by the Securities and Exchange Commission in connection with the same stock transactions.

so long as someone is defrauded in the offer or sale of securities.

While we agree with the government's statement of the issue in this case, we do not agree with the government's analysis of the requirements of 15 U.S.C. § 77q(a)(1). It is clear that as between appellant and the brokers, there was no offer or sale of securities. Appellant made phone calls to the various brokers, during which he allegedly made a number of fraudulent statements, but he did not propose to sell any securities to the brokers alleged to have been defrauded. Appellant did request that the brokers find purchasers for appellant's stock and did authorize sales for his account. A stockbroker does not become the purchaser of stock when an owner requests that the broker sell certain of the owner's securities. The ordinary relationship of a stockbroker to his customer is that of principal and agent. *See Galiger* v. *Jones*, 129 U.S. 193 (1889); *McMann* v. *Securities and Exchange Commission*, 87 F.2d 377 (2d Cir. 1937). And the facts here clearly indicate that the stockbrokers were acting as agents of appellant, with the limited authority to find persons willing to purchase appellant's stock and subsequently to transfer the stock to the purchasers.

The third party purchasers to whom the brokers sold were not deceived or defrauded in any way. They received the securities from the brokers and paid the price they had contracted to pay.

The legislative purpose in enacting 15 U.S.C. § 77q (a)(1) was to protect investors from fraudulent

practices in the sale of securities. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976); *Securities and Exchange Commission* v. *International Chem. Dev. Corp.*, 469 F.2d 20, 26 (10th Cir. 1972); *Superintendent of Ins. of the State of New York* v. *Bankers Life & Cas. Co.*, 300 F.Supp. 1083, 1094 (S.D. N.Y.), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd on other grounds*, 404 U.S. 6 (1971); *Dolgow* v. *Anderson*, 43 F.R.D. 472, 482 (E.D. N.Y. 1968).

As Mr. Justice Powell noted in *Ernst*, *supra*, 425 U.S. at 194, federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929. In the decade prior to 1933 the investing public suffered losses through investments in worthless securities estimated at twenty-five billion dollars. S.Rep. No. 47, 73rd Cong., 1st Sess., 2, to accompany S.875 (April 27, 1933). At the time there was national concern with public sales of worthless stock to persons who had no means of adequate protection and emphasis upon protecting the investing public from exploitation through sales of unsound, fraudulent and worthless securities. In a message to the Congress President Franklin D. Roosevelt on March 29, 1933 said in part:

> In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.
>
> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their

value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.

"Regulation of Security Issues," Message from the President of the United States, March 29, 1933. *House Document* No. 12, 73rd Congress.

It was against this backdrop that the Securities Act of 1933, including the section now codified as 15 U.S.C. § 77q(a)(1), was adopted. And it is against this backdrop that we are constrained to hold that the government must prove some impact of the scheme on an investor. *United States* v. *Ashdown*, 509 F.2d 793, 799 (5th Cir.), *cert. denied*, 423 U.S. 829 (1975), *quoting United States* v. *Schaefer*, 299 F.2d 625, 629-30 (7th Cir. 1962).

Our resolve is strengthened by reference to the general principle that statutes creating crimes are to be strictly construed in favor of the accused and before one may be punished it must appear that his

case is plainly within the statute. *United States* v. *Harris*, 544 F.2d 947, 949 (8th Cir. 1976); *United States* v. *Freeman*, 473 F.2d 7, 9 (8th Cir. 1973); *Jacobs* v. *United States*, 359 F.2d 960, 964 (8th Cir. 1966).

Moreover, the government has cited and our research has uncovered no case in which 15 U.S.C. § 77q(a)(1) has been used to prosecute a defendant for fraud in the sale of securities perpetrated upon an agent-broker, where no investor has been deceived or defrauded as a result of the fraud. We decline to expand the scope of 15 U.S.C. § 77q(a)(1) to encompass the facts of the present case.

Turning now to Count VI of the indictment, as indicated it may be observed that the evidence shows that on August 28, 1969 Naftalin called H. S. Kipnis & Co. (Kipnis) to sell 1,000 shares of Fairchild Camera (Fairchild). Kipnis, which both bought and sold Fairchild for its own account, executed the order by purchasing the shares.[4]

The evidence is somewhat conflicting as to representations, if any, made by Naftalin in connection with the sale and as to whether Naftalin was in fact "short." There are also facts including the fact of a substantial post sale payment on the Kipnis account by Naftalin in September, 1969 tending perhaps to show lack of fraudulent intent never to deliver stock or pay a debit balance.

[4] We are not advised as to whether Naftalin knew immediately that Kipnis was the purchaser; however, in due course of business he learned the identity of the purchaser to whom he had sold.

On the other hand, there is strong evidence tending to support a finding of guilt.

Nevertheless, the conviction under Count VI must be reviewed precisely as the other counts were reviewed even though a sale to Kipnis was in evidence.

In passing upon pretrial motions the district court ruled that the entire indictment was not subject to dismissal on the ground that it did not charge Naftalin with having defrauded "purchasers," and rejected the government's argument that it could satisfy the purchaser requirement by proving that certain shares were sold to Kipnis.

In rejecting the government's argument, the trial court noted the indictment did not allege that Kipnis was a purchaser and observed that the defendant could not be tried on charges that were not made. Accordingly, the trial court concluded this portion of its reasoning by announcing that the government would be limited at trial to proof of violations of § 17 (a)(1). Under the statutory construction applied by the trial court this meant, of course, that proof of the fact of purchase by Kipnis was not to be considered essential at trial. Indeed, as the government concedes with commendable candor, fraud on the purchaser as purchaser was not charged.

Thus we have an anomolous situation in which we have held that the theory and facts upon which the case went to trial do not permit conviction, but in which we perhaps could sustain a conviction had the defendant been put to trial upon another basis.

In the circumstances, we must vacate the conviction on Count VI also.

The judgments of conviction are vacated and the indictment shall be dismissed.

ROSS, Circuit Judge, Concurring and Dissenting.

I concur in the disposition of all of the counts except Count VI. I would affirm the conviction as to Count VI.

A true copy.

Attest:

Clerk, U. S. Court of Appeals,
Eighth Circuit

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

SEPTEMBER TERM, 1977

No. 77-1290

[Filed June 13, 1978]

THE UNITED STATES, APPELLEE

vs.

NEIL T. NAFTALIN, APPELLANT

Appeal from the United States District Court for the District of Minnesota

JUDGMENT

THIS CAUSE came on to be heard on the designated record of the United States District Court for the District of Minnesota and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court, that the judgment and sentence of the said District Court as to Counts I-V, VII and VIII be and is hereby reversed.

And it is further ordered by this Court that this cause as to Count VI be and is hereby vacated and

the indictment shall be dismissed in accordance with the majority opinion of this Court.

June 13, 1978

[SEAL]

A true copy:

Attest:

/s/ Robert C. Tucker
Clerk, U. S. Court of Appeals,
8th Circuit

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

SEPTEMBER TERM, 1977

No. 77-1290

[Filed August 4, 1978]

THE UNITED STATES, APPELLEE

vs.

NEIL T. NAFTALIN, APPELLANT

Appeal from the United States District Court for the District of Minnesota

The Court having considered petition for rehearing en banc filed by counsel for appellee and, being fully advised in the premises, it is ordered that the petition for rehearing en banc be, and it is hereby, denied.

Considering the petition for rehearing en banc as a petition for rehearing, it is ordered that the petition for rehearing also be, and it is hereby, denied.

August 4, 1978

[SEAL]

A true copy:

Attest:

/s/ Robert C. Tucker
Clerk, U. S. Court of Appeals,
8th Circuit

APPENDIX D

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

Cr. No. 4-74-73

UNITED STATES OF AMERICA

v.

NEIL T. NAFTALIN

FINDINGS OF FACT, CONCLUSIONS OF LAW AND VERDICT

The above-entitled criminal matter came on for trial December 14, 1976, before the Court (a jury having been waived) on an eight-count indictment, each count charging Neil T. Naftalin with a violation of Title 15, United States Code, Section 77(q)(a).

Upon all of the evidence presented at trial, the Court finds as follows:

1. From on or about February 10, 1960, and continuing thereafter up to and including the present, Naftalin & Co., Inc., a corporation duly organized under and by virtue of the laws of the State of Minnesota, maintains its principal offices in Minneapolis, Minnesota. Since February 25, 1960 and continuous thereafter up to May 17, 1973, Naftalin & Co., Inc., was registered with the Securities and Exchange Commission pursuant to Section 15(b) of the Securi-

ties Exchange Act, Title 15, United States Code, Section 78*o*(b). Naftalin & Co., Inc., was also a member of the National Association of Securities Dealers, Inc., a national securities association registered pursuant to Section 15A of the Securities Exchange Act, Title 15, United States Code, Section 78*o*-3, since 1960. From the time of its registration in 1960 through approximately the end of 1962, Naftalin & Co., Inc., conducted a general securities business in the over-the-counter market from its offices in Minneapolis, Minnesota. Since 1963 through December, 1969, except for a few isolated transactions, Naftalin & Co. did not conduct a public business, but rather traded for its own account through various broker/dealers.

2. At all times since its incorporation, Neil T. Naftalin, defendant herein, was President, principal executive officer, and majority shareholder of Naftalin & Co., Inc. Neil T. Naftalin was an experienced, knowledgeable and sophisticated investor and was familiar with the customs and terminology used in the trade.

3. From July 22, 1969 through August 28, 1969, Neil T. Naftalin knowingly employed a scheme and artifice to defraud Paine, Webber, Jackson and Curtis, Piper, Jaffray and Hopwood, Inc., Dain, Kalman and Quail, Inc., Merrill Lynch, Pierce, Fenner and Smith, Inc., and H. S. Kipnis & Co., Inc.

As a part of said scheme and artifice to defraud the above firms, Neil T. Naftalin placed sell orders with the above firms for the cash account of Naftalin

& Co., Inc., for the stocks of American Research and Development, Avon Products, Inc., Burroughs Corporation, Control Data Corporation, and Fairchild Camera and Instrument. In each instance defendant Naftalin represented Naftalin & Co. to be "long" in the stock, either by direct statement to that effect or by using words and phrases in placing the sell order which would be understood in the trade as a representation that Naftalin & Co. was "long" in the stock. In each instance Naftalin & Co. was "short" the stock involved. Neil T. Naftalin knew that each of the firms would not have accepted the sell orders, except that giving rise to Count 6 of the indictment, had they known that Naftalin & Co. was "short" the stock. They either would not have taken the sell order at all or would have required a margin deposit. As to Count 6, the short sale of 1000 shares of Fairchild Camera through H. S. Kipnis & Co., Kipnis would not have required margin because it dealt in that stock as a principal, but, as Neil T. Naftalin knew, it would have refused to complete the transaction had it known that Naftalin & Co. was not in a position to deliver the stock as represented by Neil T. Naftalin.

As a part of the scheme and artifice to defraud the above firms in the sell orders placed with respect to the above stocks, Neil T. Naftalin lulled the above firms into believing Naftalin & Co. was long in the stocks by responding to the firms' demands for delivery of the stock with assertions that Naftalin & Co. was "long" and the stock was on its way to Naftalin

& Co. from other brokers, banks, or transfer agents. None of the securities sold by Naftalin & Co. in the transactions alleged in the indictment were delivered by Naftalin & Co. Each broker had to buy the securities in (and in all but one case, said buy ins were at a loss).

4. With respect to Count One, Neil T. Naftalin employed the scheme to defraud, described in paragraph 3 herein, by placing a sell order for 500 shares of American Research and Development with Paine, Webber, Jackson and Curtis on July 22, 1969, and caused said firm to send and deliver by United States mail an envelope addressed to Naftalin & Co. containing a written confirmation of that sale.

5. With respect to Count 2, Neil T. Naftalin employed the scheme to defraud described in paragraph 3 hereby placing a sell order for 1000 shares of Burroughs Corporation with Paine, Webber, Jackson and Curtis on August 5, 1969, and caused said firm to send and deliver by United States mail an envelope addressed to Naftalin & Co. containing a written confirmation of that sale.

6. With respect to Count 3, Neil T. Naftalin employed the scheme to defraud described in paragraph 3 herein by placing a sell order for 1000 shares of Burroughs Corporation with Piper, Jaffray & Hopwood, Inc., on August 7, 1969, and caused said firm to send and deliver by United States mail an envelope addressed to Naftalin & Co. containing a written confirmation of that sale.

7. With respect to Count 4, Neil T. Naftalin employed the scheme to defraud described in paragraph 3 herein by placing a sell order for 1000 shares of Control Data Corporation with Dain, Kalman and Quail, Inc., on August 8, 1969, and caused said firm to send and deliver by United States mail an envelope addressed to Naftalin & Co. containing a written confirmation of that sale.

8. With respect to Count 5, Neil T. Naftalin employed the scheme to defraud described in paragraph 3 herein by placing a sell order for 500 shares of American Research and Development with Merrill Lynch, Pierce, Fenner and Smith, Inc., on August 20, 1969, and caused said firm to send and deliver by United States mail an envelope addressed to Naftalin & Co. containing a written confirmation of that sale.

9. With respect to Count 6, Neil T. Naftalin employed the scheme to defraud described in paragraph 3 herein by placing a sell order for 1000 shares of Fairchild Camera and Instrument Corporation with H. S. Kipnis & Co. on August 28, 1976, and in placing such sell order the defendant used a communication in interstate commerce, that is, a telephone call from Minnesota to Illinois.

10. With respect to Count 7, Neil T. Naftalin employed the scheme to defraud described in paragraph 3 herein by placing a sell order for 500 shares of American Research and Development with H. S. Kipnis & Co. on August 4, 1969, and in placing such sell order the defendant used a communication in interstate commerce, that is, a telephone call from Minnesota to Illinois.

11. With respect to Count 8, Neil T. Naftalin employed the scheme to defraud described in paragraph 3 herein by placing a sell order for 1000 shares of Avon Products, Inc., with H. S. Kipnis & Co. on August 1, 1969, and in placing such sell order the defendant used a communication in interstate commerce, that is, a telephone call from Minnesota to Illinois.

From the above facts, the Court finds that as to each count the government has proven beyond a reasonable doubt that Neil T. Naftalin employed a scheme or artifice to defraud in the sale of securities and has used the mails or a communication in interstate commerce in said scheme.

As to each count of the indictment, the Court finds that the defendant acted as charged in the count wilfully and knowingly.

The Court finds the defendant guilty of each count in the indictment.

/s/ Earl R. Larson
United States District Judge

Dated: February 1, 1977.

☆ U. S. GOVERNMENT PRINTING OFFICE; 1978 274154 127